CALIFORNIA CORPORATE DISCLOSURE ACT
NEW AND IMPROVED AS OF SEPTEMBER 27, 2004

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Following on the heels of Enron and its progeny, the California Legislature adopted the California Corporate Disclosure Act in 2002. The Disclosure Act required public companies to attach supplements to the annual statements (commonly called the Statement of Officers) filed with the California Secretary of State identifying their key executive officers, board members and agent for service of process. This public supplement requires short statements in three major subject areas: (a) the corporation's auditor relationships; (b) certain so-called "bad acts;" and (c) management compensation and transactions.

The Disclosure Act was intended to give the public a snapshot of a corporation's management relationships without poring through long, and allegedly incomprehensible, SEC filings. Despite its good intentions, the Disclosure Act left companies with many practical difficulties stemming from definitional and policy ambiguities that made competent compliance a nearly impossible task. [See the author's earlier article, "California's New Corporate Disclosure Law, Practical Solutions to Problems Raised in Completing the New Public Company Disclosure Statement." 2003 *Business Law News*, Vol. XXIV, Issue 2.]

On September 27, 2004, Governor Arnold Schwarzenegger signed Assembly Bill 1000 which amended the Disclosure Act and cured many of the difficulties caused by the original enactment. The purpose of this article is to provide readers with a prompt overview of the changes made by AB 1000. A more detailed explanation of the questions that remain after enactment of AB 1000 will be the subject of a later article.

Changed Time of Filing

Under the original version of the Act, the public supplement was an attachment to the annual (or semiannual in some cases) Statement of Officers that had to be filed identifying around the anniversaries of the corporation's date of incorporation. This meant that different companies had to file at different times of the year.

This timing problem has been substantially solved by AB1000. Under the amended Act, the report by public companies is now separated from the Statement of Officers. This report (referenced in the rest of this article as the "Corporate Disclosure Statement") is now due at the same time for all reporting companies: within 150 days after the end of each fiscal year. *Corp. Code §1502.1(a).* This makes the Corporate Disclosure Statement due at about the same time as the company's Form 10-K report to the SEC.

Clearer Definition of "Public Company"

Now, only corporations must file the Statement, and the amendment clarified the meaning of "public" for purposes of the Disclosure Act. Under the amendments, a company required to file the Corporate Disclosure Statement is one that is:

> " . . . a corporation . . . that is an issuer as defined in Section 3 of the Securities Exchange Act of 1934, as amended (15 U.S.C. Sec. 78c), and has at least one class of securities listed or admitted for trading on a national securities exchange, on the National or Small-Cap Markets of the NASDAQ Stock Market, on the OTC-Bulletin Board, or on the electronic service operated by Pink Sheets, LLC."

Corp. Code §1502.1(b)(1).

Thus, as amended, only corporate issuers with securities listed on the U.S. based exchanges or established U.S. markets must file the Corporate Disclosure Statement.

Content of the Report

Auditor Relations

Under the amendments, corporations are now required to report three items:

(a) The name of the auditor who prepared the company's latest audit report,

(b) The name of the auditor employed on the date of the Corporate Disclosure Statement if the company has changed auditors, and

(c) A description of the other services rendered by the auditor who prepared the latest report or " . . .its parent corporation, or by a subsidiary or corporate affiliate of the independent auditor or its parent corporation."

Corp. Code §1502.1(a)(1)-(3).

The time period for reporting other services is also changed to include the two most recent fiscal years and the time between the end of the last fiscal year and the date of the Statement. *Corp. Code §1502.1(a)(2).*

The amendments eliminate the requirement for filing the auditor report, clarify the time period for which non-audit services are to be reported, and clarify the auditor identity information. This removes the potential conflict with company auditors over publishing audit reports. But companies still must be careful in identifying non-audit services to be reported.

Of course, the issue of non-audit services has lost much of its significance in light of legislative and regulatory enactments requiring divestiture by accounting firms of their non-audit affiliates

and tightenng the independence requirements for corporate auditors. For example, the Sarbanes-Oxley Act prohibits auditors from performing most of the non-audit consulting services that were a mainstay of the practices of many accounting firms. *15 U.S.C. §§78j-1 and 7233(b).* Also see the CPA cooling off period set forth in *Calif. Bus. & Prof. Code §5062.2.*

Director and Officer Relations

Two major ambiguities were raised by the definitions in the Disclosure Act regarding a company's officers and directors: the types of management compensation to be reported and the determination of which officers were to be disclosed in the Corporate Disclosure Statement.

Officers Whose Information Must be Reported

It was difficult to determine which corporate officers were covered by the original Disclosure Act. For example, the original act only stated that compensation had to be reported on the members of the board of directors and "the five most highly compensated officers of the company, excluding any officer who is also a member of the board of directors." Even though the Act used the "executive" adjective, just as in SEC regulations under the Exchange Act, the literal text based disclosure on compensation level, not the officer's true role with the company. Accordingly, a successful commission salesman might have had to be reported, but not the Chief Financial Officer or Secretary.

The amended Disclosure Act still requires disclosure of "the five most highly compensated officers of the company, excluding any officer who is also a member of the board of directors." Now, however, the gating term "executive officer" is limited to the same group as is covered by SEC requirements under the Exchange Act:

> " . . . [T]he chief executive officer, president, any vice president in charge of a principal business unit, division, or function, any other officer of the corporation who performs a policymaking function, or any other person who performs similar policymaking functions for the corporation."

See *SEC Exchange Act Rule 3b-7* and *Corp. Code §1502.1(b)(2).*

With this change, corporations may draw on their reporting experience under Federal law in identifying the officers to be reported. However, even though the definitional ambiguity has been resolved, California still requires disclosure of five officers in addition to any officers who are also directors. If any of the five most highly compensated officers are also directors, information on the next five officers down the list must be provided and, in all cases, the compensation of the Chief Executive Officer must be reported.

If the corporation does not have sufficient executive officers to report, it would be a good idea to make a statement to that effect in the Corporate Disclosure Statement. Otherwise, the Secretary of State might believe that the omission was an error and may reject the Statement.

Reportable Compensation

The disclosure requirement for annual compensation was improved considerably. The statute's original definition left several ambiguities regarding the compensation. Under the amended Disclosure Act, the definition of compensation incorporates Rule 402 of the SEC's Regulation S-K, bringing it into conformity with Federal reporting requirements and eliminating the ambiguities that were contained in the original Act. The amended Act requires disclosure of:

> "The compensation for the most recent fiscal year of the corporation . . , including the number of any shares issued, options for shares granted, and similar equity-based compensation granted . . .."

Corp. Code §1502.1(a)(4). The above requirement clarified the time period for which compensation had to be reported. It also clarifies that only an option grant must be reported, not vesting or exercise, for example.

The new Act also includes a definition of compensation, which had been lacking from the original enactment. Compensation is now defined as:

> " . . . all plan and nonplan compensation awarded to, earned by, or paid to the person for all services rendered in all capacities to the corporation and to its subsidiaries, as the compensation is specified by Item 402 of Regulation S-K of the Securities and Exchange Commission (Section 229.402 of Title 17 of the Code of Federal Regulations)."

Corp. Code §1502.1(b)(3).

Loans to Directors

The Disclosure Act still requires reporting of loans to a corporation's directors. However, the vague formulation has been substantially improved. The new Act requires reporting of:

> " . . . any loan, including the amount and terms of the loan, made to any member of the board of directors by the corporation during the corporation's two most recent fiscal years at an interest rate lower than the interest rate available from unaffiliated commercial lenders generally to a similarly-situated borrower."

Corp. Code §1502.1(a)(5). While this still requires reporting of information that does not exactly conform to a Federal reporting requirement, the new definition clears up many of the earlier ambiguities. Corporations now know which time periods are covered, and the old term "preferential interest rate" is replaced with a standard for comparison that should be readily measurable.

In addition, the term "Loan" is specifically defined under the new Act to exclude advances that occur in the ordinary course and are permitted by other sections of the Corporations Code; i.e. "

. . . advance for expenses permitted under subdivision (d) of Section 315, the corporation's payment of life insurance premiums permitted under subdivision (e) of Section 315, and an advance of expenses permitted under Section 317." *Corp. Code §1502.1(b)(4).*

The So-called "Bad Acts" Disclosures

The original Disclosure Act required reporting of three types of so-called "bad acts:" (a) bankruptcy filings by corporate directors, (b) fraud convictions of corporate directors and (c) securities or banking law violations by the corporation. The new Act requires similar reporting, but it includes clarifications, like the other amendments, to conform some of the requirements to Federal law and clarify ambiguities. Under the new Act, the events to be reported are:

> Bankruptcy Filings. "A statement indicating whether an order for relief has been entered in a bankruptcy case with respect to the corporation, its executive officers, or members of the board of directors of the corporation during the 10 years preceding the date of the statement." *Corp. Code §1502.1(a)(6).*
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> Fraud Convictions. "A statement indicating whether any member of the board of directors or executive officer of the corporation was convicted of fraud during the 10 years preceding the date of the statement, if the conviction has not been overturned or expunged." *Corp. Code §1502.1(a)(7).*
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> Legal Proceedings. "A description of any material pending legal proceedings, ... as specified by Item 103 of Regulation S-K of the Securities Exchange Commission (Section 229.103 of Title 12 of the Code of Federal Regulations). A description of any material legal proceeding during which the corporation was found legally liable by entry of a final judgment or final order that was not overturned on appeal during the five years preceding the date of the statement." *Corp. Code §1502.1(a)(8).*

Perhaps the most important of the changes in this area was the replacement of the reporting of unlitigated securities law violations with the Federal definition of legal proceedings.

Application to Foreign Corporations

The Disclosure Act also requires disclosure of the same information about public companies not incorporated in California as it does for California corporations. *See Corp. Code §2117.1.*

Unfortunately, in the course of its effort to fix the timing problem discussed above, the Legislature expanded the reach of the Disclosure Act to any corporation, wherever located, which meets the Act's definition of a public company. Now, all corporations with publicly traded securities (as defined) must file the new version of the "Public Company Statement" even if they have no connection with California.

Sample Corporate Disclosure Statement

A sample of the new form prescribed by the Secretary of State follows at the end of this article. The form does not provide a great deal of room for clarifications and explanations of information. However, in cases where such explanations are required, the author is informed by the Secretary of State's office that they will accept fairly brief attachment pages when corporations consider them necessary.

Conclusion

Substantial improvements have been made by the amendments in AB 1000. However, Governor Schwarzenegger noted in his message to the Assembly when he signed the bill:

> "California is the only state in the nation to impose these burdensome and duplicative reporting requirements on business.
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> "Although this bill does begin to fix the problems with the California Corporate Disclosure Act, I am directing the Department of Corporations to review the efficacy of the California Corporate Disclosure Act and, if appropriate, to consider sponsoring legislation to eliminate the duplicative requirements and further align its provisions with federal reporting requirements."

More work needs to be done and, as indicated, a discussion of the remaining issues will be included in a later article. Nevertheless, the Secretary of State (the original sponsor of the Act) and the Legislature have made significant progress in improving the balance between the need to provide investors with easy to obtain information and the need to avoid undue burdens on corporations in the increasingly regulated environment in which corporations must operate in recent times.

None of the modifications in the Act, however, change the reality that the Corporate Disclosure Statement is a public document from which material liability can flow. Therefore, any company which will file the statement must place responsibility for the Corporate Disclosure Statement under the control of its legal compliance and chief financial officers. Care must also be taken to assure conformity between these Statements and other public disclosures made by the company.